

Indiana Orthopaedic Hospital, LLC

Accountants' Report and Financial Statements

December 31, 2007 and 2006

Indiana Orthopaedic Hospital, LLC
December 31, 2007 and 2006

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Independent Accountants' Report

Board of Managers
Indiana Orthopaedic Hospital, LLC
Indianapolis, Indiana

We have audited the accompanying balance sheets of Indiana Orthopaedic Hospital, LLC (Hospital) as of December 31, 2007 and 2006, and the related statements of income, members' equity and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Hospital's investment in Southeast Surgery Center, LLC, a 50%-owned affiliate, stated at \$2,811,203 at December 31, 2007 or its equity in earnings of that affiliate of \$2,138,531, which is included in net income for the year then ended as described in Notes 9 and 10 to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in Southeast Surgery Center, LLC or the equity in its earnings by other auditing procedures.

As discussed in Note 10 to the financial statements, the Hospital acquired OI South, LLC in a business combination on July 1, 2007. The Hospital recorded the acquisition at the historical carrying value of the assets acquired, which, in our opinion, is not in accordance with accounting principles generally accepted in the United States of America that require a business combination to be recorded based on the fair values of the consideration given and of the assets acquired using the purchase method of accounting. The effects of this matter on the financial statements are not reasonably determinable.

In our opinion, except for the effects on the 2007 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the Southeast Surgery Center, LLC investment and earnings as discussed in the second preceding paragraph and of not accounting for the acquisition of OI South, LLC using the purchase method of accounting as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of Indiana Orthopaedic Hospital, LLC as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

BKD, LLP

March 17, 2008

Indiana Orthopaedic Hospital, LLC

Balance Sheets December 31, 2007 and 2006

Assets

	2007	2006
Current Assets		
Cash and cash equivalents	\$ 6,107,078	\$ 5,766,592
Patient accounts receivable, net of allowance: 2007 - \$500,000; 2006 - \$750,000	10,221,068	9,022,271
Due from affiliate	25,049	27,420
Supplies	705,533	829,162
Prepaid expenses and other	927,086	921,973
Total current assets	<u>17,985,814</u>	<u>16,567,418</u>
Property and Equipment, At Cost		
Land and land improvements	778,901	778,901
Buildings and improvements	135,250	99,007
Equipment	13,310,586	13,107,755
	<u>14,224,737</u>	<u>13,985,663</u>
Less accumulated depreciation	9,169,396	5,796,959
	<u>5,055,341</u>	<u>8,188,704</u>
Other Assets		
Investment in affiliate	2,811,203	-
Other	233,225	96,713
	<u>3,044,428</u>	<u>96,713</u>
Total assets	<u>\$ 26,085,583</u>	<u>\$ 24,852,835</u>

Liabilities and Members' Equity

Current Liabilities		
Accounts payable	\$ 3,073,805	\$ 2,173,358
Accrued expenses	1,099,872	550,723
Current maturities of capital leases payable	2,272,384	3,093,139
Estimated amounts due to third-party payers	378,690	400,000
Due to affiliate	648,407	287,794
Other	958,000	-
Total current liabilities	<u>8,431,158</u>	<u>6,505,014</u>
Long-Term Debt		
Capital leases	1,969,829	4,244,727
Total liabilities	<u>10,400,987</u>	<u>10,749,741</u>
Members' Equity		
Contributed capital	6,302,764	4,337,182
Accumulated earnings	9,381,832	9,765,912
Total members' equity	<u>15,684,596</u>	<u>14,103,094</u>
Total liabilities and members' equity	<u>\$ 26,085,583</u>	<u>\$ 24,852,835</u>

Indiana Orthopaedic Hospital, LLC

Statements of Income Years Ended December 31, 2007 and 2006

	2007	2006
Operating Revenues		
Net patient service revenue	\$ 67,420,526	\$ 59,255,154
Other	522,511	379,879
Total operating revenues	<u>67,943,037</u>	<u>59,635,033</u>
Expenses and Losses		
Salaries and wages	13,635,647	10,667,625
Employee benefits	2,702,865	2,452,836
Purchased services and professional fees	3,489,284	3,912,556
Medical supplies	18,537,281	17,269,939
Facility expense	6,954,498	6,632,572
Depreciation and amortization	3,372,437	3,253,627
Interest	445,697	698,637
Provision for uncollectible accounts	720,172	15,705
Other expenses	1,823,044	1,454,209
Total operating expenses	<u>51,680,925</u>	<u>46,357,706</u>
Operating Income	<u>16,262,112</u>	<u>13,277,327</u>
Other Income		
Income from joint venture activities	2,138,531	-
Investment return	233,918	128,028
Other	5,000	10,835
	<u>2,377,449</u>	<u>138,863</u>
Net Income	<u>\$ 18,639,561</u>	<u>\$ 13,416,190</u>

Indiana Orthopaedic Hospital, LLC

Statements of Members' Equity Years Ended December 31, 2007 and 2006

	Contributed Capital	Accumulated Earnings	Total
Balance, January 1, 2006	\$ 4,337,182	\$ 1,599,722	\$ 5,936,904
Net income	-	13,416,190	13,416,190
Distributions to members	-	(5,250,000)	(5,250,000)
Balance, December 31, 2006	4,337,182	9,765,912	14,103,094
Net income	-	18,639,561	18,639,561
Membership units issued	1,965,582	-	1,965,582
Distributions to members	-	(19,023,641)	(19,023,641)
Balance, December 31, 2007	<u>\$ 6,302,764</u>	<u>\$ 9,381,832</u>	<u>\$ 15,684,596</u>

Indiana Orthopaedic Hospital, LLC

Statements of Cash Flows Years Ended December 31, 2007 and 2006

	2007	2006
Operating Activities		
Net income	\$ 18,639,561	\$ 13,416,190
Items not requiring (providing) cash		
Depreciation and amortization	3,372,437	3,253,627
Undistributed earnings of joint venture	(1,468,531)	-
Provision for uncollectible accounts	720,172	15,705
Changes in		
Patient accounts receivable, net	(1,918,969)	(567,099)
Estimated amounts due from and to third-party payers	(21,310)	400,000
Accounts payable and accrued expenses	1,812,580	1,095,476
Other current assets and liabilities	940,003	509,299
Net cash provided by operating activities	<u>22,075,943</u>	<u>18,123,198</u>
Investing Activity - purchase of property and equipment	<u>(239,074)</u>	<u>(1,871,900)</u>
Financing Activities		
Net payment under a letter-of-credit agreement	-	(4,000,000)
Principal payments under capital lease obligations	(3,095,653)	(2,874,253)
Issuance of membership units	622,911	-
Distributions to members	(19,023,641)	(5,250,000)
Net cash used in financing activities	<u>(21,496,383)</u>	<u>(12,124,253)</u>
Increase in Cash and Cash Equivalents	340,486	4,127,045
Cash and Cash Equivalents, Beginning of Year	<u>5,766,592</u>	<u>1,639,547</u>
Cash and Cash Equivalents, End of Year	<u><u>\$ 6,107,078</u></u>	<u><u>\$ 5,766,592</u></u>
Supplemental Cash Flows Information		
Interest paid	\$ 445,697	\$ 698,637
Fixed assets purchases included in accounts payable	-	209,920
Capital lease obligation incurred for property and equipment	-	137,524
Non-cash portion of consideration of membership units issued	1,342,671	-

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Indiana Orthopaedic Hospital, LLC (Hospital) primarily earns revenues by providing inpatient and outpatient musculoskeletal and related surgical services to patients in the greater Indianapolis, Indiana area.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

The Hospital considers all liquid investments with original maturities of three months or less to be cash equivalents. At December 31, 2007 and 2006, cash equivalents consisted primarily of money market funds.

Investment Return

Investment return is comprised primarily of interest income earned on the operating cash accounts.

Patient Accounts Receivable

The Hospital reports patient accounts receivable for services rendered at net realizable amounts from third-party payers, patients and others. The Hospital provides an allowance for doubtful accounts based upon a review of outstanding receivables, historical collection information and existing economic conditions. As a service to the patient, the Hospital bills third-party payers directly and bills the patient when the patient's liability is determined. Patient accounts receivable are due in full when billed. Accounts are considered delinquent and subsequently written off as bad debts based on individual credit evaluation and specific circumstances of the account.

Supplies

The Hospital states supply inventories at the lower of cost, determined using the first-in, first-out method or market.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Property and Equipment

Property and equipment are depreciated on a straight-line basis over the estimated useful life of each asset. Assets under capital lease obligations and leasehold improvements are depreciated over the shorter of the lease term or their respective estimated useful lives.

Investment in Affiliate

Effective July 1, 2007, the Hospital entered into a joint venture agreement with an Indianapolis health care provider to jointly operate Southeast Surgery Center, LLC. (d/b/a Indiana Orthopaedic Surgery Center), an ambulatory surgery center on the south side of Indianapolis. The Hospital's investment in this joint venture is accounted for under the equity method of accounting with the associated earnings being reported as other income in the accompanying operating statement.

Net Patient Service Revenue

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers and others for services rendered and includes estimated retroactive revenue adjustments. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such estimated amounts are revised in future periods as adjustments become known.

Charity Care

The Hospital provides charity care to patients who are unable to pay for services. The amount of charity care is included in net patient service revenue and is not separately classified from the provision for uncollectible accounts.

Estimated Malpractice Costs

Estimated malpractice costs, if any, include estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Income Taxes

The Hospital is organized as a pass-through Limited Liability Corporation under the Internal Revenue Code. As such, the Hospital is not taxed at the corporate level and income is passed through to the members of the Hospital at the individual level. Accordingly, the Hospital does not recognize income taxes in the accompanying financial statements.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 2: Net Patient Service Revenue

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. These payment arrangements include:

Medicare. Inpatient acute care services and substantially all outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. The Hospital is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary.

Medicaid. Inpatient acute care services and substantially all outpatient services rendered to Medicaid program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors.

The Hospital has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates. Approximately 30% of the Hospital's receivables are due from a single commercial insurance carrier for the years ended December 31, 2007 and 2006.

The Medicare Modernization Act of 2003 contained an 18 month moratorium on the development of new physician-owned "specialty hospitals", as such hospitals are defined in the statute, the expansion of services by specialty hospitals and certain ownership changes in specialty hospitals. This moratorium expired during 2005. There is currently discussion regarding potential legislation that might impact specialty hospitals, ranging from disclosures to a new moratorium to prohibition of specialty hospitals. Management can not estimate the long-term impact of any future legislation on the Hospital given the uncertainty involved with the regulatory changes.

Note 3: Limited Liability Company

The Hospital is organized as an Indiana limited liability company and began operations in March 2005. Prior to July 1, 2007, the Hospital was owned by two LLC's that each share in a combined and issued 100 member units. Effective July 1, 2007, these units were replaced with three classes of units and members, referred to as Classes A, B and C. A related discussion of the July 1, 2007 transaction is more fully described in Note 10.

The Hospital is governed by a seven member board of managers. The board of managers is generally responsible for the direction and management of the Hospital. Only Class A members can serve on the governing board of managers.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Class A members control a total 11,388 units and generally receive a pro-rata percentage of operating profits from the Hospital as defined in the operating agreement. Class A members voting responsibilities include the election of members to serve on the board of managers. They vote on all matters subject to a membership vote and also retain certain reserved powers. The reserved powers limit certain decisions that can only be decided by Class A members and also limit when Class B members can vote on general membership voting matters.

Class B members provide up to a total of 6,592 total units and generally received a pro-rata percentage of operating profits from the Hospital, with certain limitations, as defined in the operating agreement. Their units allow them to vote on matters submitted to the membership; however, the Class A members reserved powers may limit the ability for Class B members to vote on certain matters.

Class C member controls 244 units and received profit distributions based upon its pro rata share of profits earned from the Hospital's interest in the Southeast Surgery Center, LLC. Class C units are non-voting units.

Note 4: Medical Malpractice Coverage and Claims

The Hospital purchases medical malpractice insurance under a claims-made policy on a fixed premium basis. Accounting principles generally accepted in the United States of America require a health care provider to accrue the expense of its share of malpractice claim costs, if any, for any reported and unreported incidents of potential improper professional service occurring during the year by estimating the probable ultimate costs of the incidents. Based upon the Hospital's claim experience, no such accrual has been made. It is reasonably possible that this estimate could change materially in the near term.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 5: Long-Term Debt

	2007	2006
Capital lease obligations (A)	\$ 4,242,213	\$ 7,337,866
Less current maturities	2,272,384	3,093,139
	<u>\$ 1,969,829</u>	<u>\$ 4,244,727</u>

- (A) Capital lease obligations, payable in monthly installments ranging from \$560 to \$94,523 with an imputed interest rate of 7.5%. The leases are governed by a master lease agreement from a leasing company and all leases are generally secured by the leased equipment. The lease terms range from three to six years. Property and equipment include the following property under capital lease arrangements:

	2007	2006
Equipment	\$ 11,530,222	\$ 11,530,222
Less accumulated depreciation	8,649,134	2,687,367
	<u>\$ 2,881,088</u>	<u>\$ 8,842,855</u>

Aggregate annual payments on capital lease obligations at December 31, 2007, are:

	Capital Lease Obligations
2008	\$ 2,494,084
2009	1,384,087
2010	706,015
	<u>4,584,186</u>
Less amount representing interest	341,973
Present value of future minimum lease payments	<u>4,242,213</u>
Less current maturities	<u>2,272,384</u>
Noncurrent portion	<u>\$ 1,969,829</u>

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 6: Operating Leases

Noncancellable operating leases for the Hospital facility and certain diagnostic equipment expire through 2016. The facility leases generally contain renewal options for periods ranging from five to ten years and require the Hospital to pay all executory costs (property taxes, maintenance and insurance). The leases are secured by certain assets, as defined in the lease agreements.

Future minimum lease payments at December 31, 2007, were:

2008	\$ 4,724,836
2009	4,492,428
2010	4,582,280
2011	4,661,620
2012	4,717,968
Later years	<u>17,255,804</u>
Future minimum lease payments	<u>\$ 40,434,936</u>

Total lease expense was \$6,720,444 and \$6,103,925 for 2007 and 2006, respectively.

Note 7: Related Party Transactions

The Hospital and Orthopaedics-Indianapolis, P.C. (Ortho Indy) are related parties through common ownership. The Hospital entered into a management services agreement with Ortho Indy to provide certain management, administrative and payroll related services for the Hospital. The management service agreement also provides leased employees and their benefits to the Hospital. The agreement includes renewal options, which allow the Hospital to extend the term for successive five year periods. Reimbursed expenses to Ortho Indy amounted to \$4,445,788 and \$13,120,461 for the years ended December 31, 2007 and 2006, respectively. Amounts due from and to Ortho Indy are reported in the accompanying balance sheets as due from and to affiliates.

The Hospital building was owned by a related party and was sold during fiscal year 2006 to an unrelated third party. Rental payments to the related party during its period of ownership approximated \$2,000,000.

Note 8: Pension Plans

In March 2007, the Hospital joined the post-retirement benefit plan of Ortho Indy. The plan provides for a matching component for up to 6% of the employees' salary and also allows a discretionary profit-sharing contribution from the Hospital. Pension expense in 2007 approximated \$565,000. Prior to March 2007, the employees serving the Hospital were leased from Ortho Indy, and related costs were included in the management service agreement described in Note 6 above.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 9: Investment in Affiliate (Unaudited)

The investment in affiliate relates to a 50% ownership of the Southeast Surgery Center, LLC. The Hospital acquired an ownership in this entity on July 1, 2007. Financial position and results of operations of the investee are summarized below:

	<u>2007</u>
Current assets	\$ 4,695,558
Property and other long-term assets, net	882,490
Goodwill	<u>1,412</u>
Total assets	<u>\$ 5,579,460</u>
Accounts payable and accrued liabilities	<u>\$ (42,946)</u>
Total liabilities	<u>(42,946)</u>
Members' equity	<u>5,622,406</u>
Total liabilities and members' equity	<u>\$ 5,579,460</u>
Revenues	\$ 13,852,074
Excess of revenues over expenses	\$ 8,554,127

Note 10: Business Combinations

Effective July 1, 2007, the Hospital's two LLC members merged into the Hospital, which resulted in a reverse acquisition. The merger did not result in a change in control of the Hospital. The two LLC members were holding companies with no business operations and the transaction resulted in the Hospital receiving approximately \$500,000 of cash for the membership units issued.

Also on July 1, 2007, the Hospital acquired the assets of OI South, LLC in a business combination. OI South, LLC owned a 50% interest in the Southeast Surgery Center, LLC. The acquisition met the definition of a business combination under Financial Accounting Standards Board Statement No. 141, *Business Combinations* (FAS 141). FAS 141 requires the acquisition to be accounted for under the purchase method of accounting. Although the business combination was supported and accomplished by fair market value calculations, management elected to record the investment at the book value of the net assets received which is not in compliance with this standard. The Hospital issued approximately \$1,343,000 of various classes of membership units in exchange for the outstanding member units of OI South, LLC. The Hospital's interest in the operations Southeast Surgery Center, LLC is accounted for under the equity method of accounting subsequent to the business combination.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Note 11: Commitments and Contingencies

Line of Credit

The Hospital is a party to a line of credit agreement with a bank providing up to \$6,500,000 in borrowings. The line of credit agreement expires May 3, 2008, and requires interest only payments at prime -1% on any outstanding balance. The agreement is secured by the Hospital's accounts receivable and the Hospital did not have any outstanding amount owed to the bank at December 31, 2007.

Litigation

The Hospital is subject to claims and lawsuits that arise primarily in the ordinary course of its activities. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position, change in net assets and cash flows of the Hospital. As such, no accrual for such losses has been recognized in the accompanying financial statements. It is reasonably possible this estimate could change materially in the near term.

West Side Project

The Hospital and Ortho Indy have entered into an agreement for the construction and development of a medical office and ambulatory surgery center complex on the west side of Indianapolis. The development was guaranteed by Ortho Indy under a lease arrangement, however, the Hospital will sublet the ambulatory surgery center from Ortho Indy. The project, which is scheduled to be completed during the 2008 fiscal year, is expected to cost approximately \$12,250,000. The Hospital is expected to occupy approximately 50% of the completed project and lease terms will be finalized once construction is finalized.

Note 12: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Those matters include the following:

Allowance for Net Patient Service Revenue Adjustments

Estimates of allowances for adjustments included in net patient service revenue are described in *Notes 1 and 2*.

Malpractice Claims

Estimates related to the accrual for medical malpractice claims are described in *Notes 1 and 3*.

Indiana Orthopaedic Hospital, LLC

Notes to Financial Statements December 31, 2007 and 2006

Admitting Physicians

The Hospital is served by a group of admitting and surgical physicians that comprise nearly 100% of the Hospital's net patient service revenue. The physician group is a related party of the Hospital through common ownership as described in *Note 6*.

Self Insurance of Employee Health Claims

The Hospital pools its share of health insurance claims with Ortho Indy, a related party. Any such accrual is included in the related party accrual described in *Note 7*.